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Playing from Strength: Canada's Trade Deal Priorities for Financial Services

Despite headwinds for trade deals, Canada should seize opportunities abroad for its dynamic financial services sector. This study identifies top markets that Canada should prioritize.

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The Study In Brief

The financial services sector plays a crucial role in the growth of the Canadian economy. How and where Canada looks abroad for opportunities will be critical in determining the future success of this industry.

The announcement by the United States President-elect that he would withdraw his country's signature from the recently concluded Trans Pacific Partnership, may in fact create the conditions for a flurry of negotiations aimed at concluding narrower deals.

This *Commentary* summarizes the important competitive strengths that Canada has built in financial and related services, and ranks the markets which Canadian trade policymakers should prioritize in order to exploit these advantages. To evaluate high priority countries for Canada's trade negotiators, we created a ranking methodology. Specifically, we sought to answer two questions that evaluate *attractiveness* and *feasibility* respectively:

- Where would opening up trade in financial services provide the greatest benefit to the Canadian economy?
- Where is it most realistic, given what we already know about these particular countries?

Results from analyzing these two questions suggest a set of five priority markets. First, is the continued importance of TPP signatories, Mexico, the United States, and Chile, all of which Canada has agreements with, as well as Australia, Japan, Malaysia and Vietnam, with which Canada does not. Although the TPP is unlikely to survive, something like it, or a "plan B" involving the TPP signatory countries, should be on the Canadian government's agenda.

China is next on our priority list. From an *attractiveness* standpoint, China ranks at the top, as it is a fast-growing emerging market but remains fairly closed, meaning there is much potential in principle for a trade agreement with that country to have a positive impact on Canada.

The next country on our priority list, India, is another large emerging economy that is strong from an *attractiveness* perspective but with whom our assessment of the *feasibility* of doing a deal is less glowing. Nevertheless, despite labour market concerns that have derailed previous attempts to conclude a trade agreement, India remains a strong candidate.

ASEAN countries such as the Philippines, Indonesia and Thailand continue to be valuable targets for Canadian trade negotiators. All have different strengths and weaknesses, but both individually and as a group they offer much from a Canadian perspective.

In the Americas, we suggest that smaller partners such as the Dominican Republic could be new and interesting targets for Canada. While not themselves powers in financial services, they have shown a clear interest in liberalizing trade, including in services, and have good growth prospects in the heart of what is a fast-evolving Caribbean basin.

Even in the current environment, Canada can likely successfully promote services trade liberalization, focusing on areas of existing and emerging advantages such as financial and related services – many of which it shares with the United States – and on markets that are likely to be more promising and receptive. Such sectoral and bilateral approaches continue to hold a lot of potential for growth.

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The Canadian economy is undergoing major structural shifts as a result of global economic headwinds and technological changes.

Amid these shifts, the number of individuals employed in traditional, high-paying jobs in manufacturing has been in decline. The resources sector, which until recently had been booming, is also now in the midst of a severe employment downturn. Although these sectors remain sources of jobs that pay well above the average and likely will experience some rebound in coming years, clearly Canadians will be looking to other industries to create or sustain future growth in jobs and incomes.

In this context, we turn our attention to a large and often unheralded portion of the Canadian economy, comprised of providers of commercial services that can and do compete successfully for clients beyond Canada's borders. The importance of these services industries to Canada's economic future can hardly be overstated: together they have added hundreds of thousands of jobs over the past 15 years, jobs that on average pay more than those in manufacturing or resources (Schwanen 2014).

Furthermore, competitiveness in many of these activities – be they logistics, research and development, maintenance, engineering, architectural, software, leasing, legal, management, insurance or banking services – is becoming critical to the goods-making sectors that rely on them. For example, the more intensive use of services by the manufacturing sector contributes to that sector's productivity and hence to its viability (USITC 2013, chap. 3). Canadians have a vital interest in ensuring that these services industries grow and compete globally, including in many countries that, in the future, likely will experience faster economic growth than Canada.

Canada's financial services industry, including banking, insurance, pensions and other investments, plays a central role among those sectors, and it has been a source of strength for Canada through the economically turbulent past decade, as we detail below. In this *Commentary*, we review and make recommendations on how Canada could best seek, through market-opening agreements, to parlay its strengths in this sector into new international business opportunities that will not only benefit the financial services and related sectors, but also generate future income growth for Canadians.

The largest players in Canada's financial services sector have already expanded significantly overseas in recent years. International assets belonging to Canada's three largest life insurers rose by 42 percent between 2009 and 2014. Large life insurers have broadened the number of markets and business lines they participate in abroad, with 50 percent of their total assets residing in foreign jurisdictions. Similarly, international assets of large Canadian banks have grown by 43 percent since 2010. Banks, however, have been more selective in how they diversify across jurisdictions: their US and Asian assets have increased both in absolute and in relative terms over the past five years, but

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their holdings in Europe and Latin America and the Caribbean have experienced a proportional decline. This more targeted geographical approach by Canadian banks is consistent with how financial institutions across the globe have reacted since the financial crisis of 2008–09. In general, financial institutions have been more selective in where they pursue foreign direct investment opportunities.[1] Although this variation in approach between banks and life insurers needs to be taken into account in any specific trade negotiations, our aim in this *Commentary* is to see which geographically targeted negotiations should be prioritized to leverage the strengths of the Canadian financial services ecosystem as a whole. We therefore do not spell out separate negotiating targets for different types of services, but we do make use of both banking and insurance-specific data to rank priority countries.

These country rankings are based on a set of criteria that we use to determine trade *feasibility* and *attractiveness*. This breakdown allows us to provide a detailed ordering of country priorities for Canada's trade negotiators. These countries include both those with which Canada has agreements, and those that should continue to be monitored for potential improvements to future access. The following list represents the five priorities we believe should be top of mind:

1.Trans-Pacific Partnership (TPP) countries including both countries we have agreements with such as Mexico, the United States, and Chile, as well as countries such as Australia, Japan, Malaysia, and Vietnam with which we do not; 2. China; 3. India; 4. Other members of the Association of Southeast Asian Nations (ASEAN), such as the Philippines, Indonesia and Thailand; and 5. The Dominican Republic.

The Importance of Financial and Related Services to Canada's Economy

Financial services – encompassing credit intermediation and related activities,[2] securities and other investments and related services, and insurance and pensions services – constitute, with transportation and communications, what have been dubbed "infrastructure services," without the efficient provision of which the rest of the economy cannot grow. Here, we review some industry characteristics that could usefully inform Canada's trade agenda.

First on our list is the importance of financial services as an employer. The industry employs relatively more Canadians with postsecondary and postgraduate degrees than the rest of the economy, and the structure of its capital (excluding financial capital) is relatively tilted toward intellectual property and buildings. In short, financial services make intensive use of the human capital Canadians have been acquiring in earnest over the past 40 years, as well as of the space and ingenuity Canada possesses in abundance.[3] A number of other services activities tend to grow in tandem with financial services, both because they are directly complementary to them (for example, accounting or legal services) or because the financial services industry relies on them extensively as inputs (such

1 See Canada (2016) for statistics and a more detailed analysis.

2 We often refer to this function as "banking" or as "financial services" on its own when the context makes it clear that it does not include insurance or other investment services. This allows us to conform with the often-inconsistent nomenclature of the various data sources we use.

3 Data on fixed and human capital structure by industry that support these statements are available upon request.

as communications, software and other information and business services). These industries are also characterized by their relatively greater intensive use of the more highly educated portion of the Canadian work force. Together, these industries have been leaders in the growth of relatively well-paying jobs in Canada so far this century (Table 1). A significant minority of these jobs depends on the industry's growth abroad: banks and insurance companies account for 41 percent of Canada's foreign direct investment (FDI) abroad, and arguably thousands of domestic head office jobs in the financial and related sectors exist to support these investments.[4]

Not surprisingly, given its increasing share of employment, the financial services sector's share of gross domestic product (GDP) has also increased (Figure 1). Of itself, of course, growth in the sector's share of the economy is neither a good nor bad thing. It depends on how efficiently the sector funnels funds toward activities that generate or sustain overall economic growth, and on whether the sector's growth diverts resources from other productive sectors (see Cechetti and Kharroubi 2015). The extent to which growth in the financial services industry positively contributes to growth in the rest of the economy therefore depends on the overall regulation and good governance of the financial system, the degree of competition within it and the openness of the industry to changes, including technological ones, that benefit customers.

One important sign of whether these factors, as they play out in the financial services industry, work to the overall benefit of Canada's economy, is whether the industry can be considered competitive by international standards. Accordingly, we now turn to some markers of Canada's competitive position in financial services, which will also inform Canada's overall approach to opening markets.

Table 1: Employment Growth in Canada's Financial and Related Services, and in Overall Economy, 2001-2015

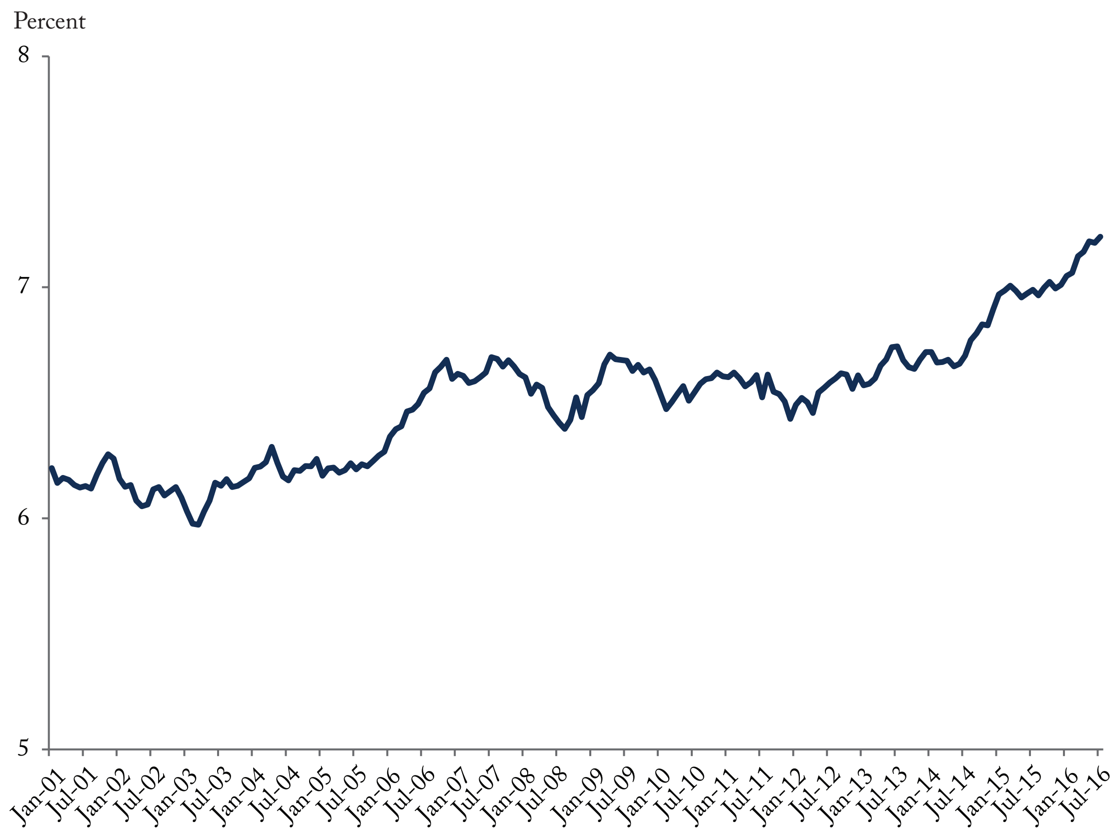
Industry (down) and Indicator (right)	Change in Employment (thousands)	Change in Employment (percent)	Average Weekly Earnings (2015)
Overall Economy	**+2,824**	**+21.8**	**$952**
Banking	+71	+24.5	$1059
Insurance	+40	+39.4	$1240
Investments	+34	+23.2	$1558
Services Most Related to Financial Services	+317	+30.8	$1029

Note: "Services Most Related to Financial Services" are data processing hosting and related services, other information services, legal services, accounting services, computer design and related services, consulting services, management of companies and entreprises and administrative and support services.

Source: Statistics Canada Table 281-0047 accessed August 14, 2016.

4 Statistics Canada does not break down the share of head office employment by industry. A simple triangulation between FDI by industry relative to total assets by industry and head office employment relative to total corporate assets in Canada's economy suggests that head office employment in the financial services sector derived from its direct foreign investments could approach five thousand.

Figure 1: Financial Services as a Percent of GDP – Monthly Data



Source: Statistics Canada CANSIM Table 379-0031.

The International Competitiveness of Canada's Financial Services Industry

The international competitive position of Canada's financial services industry cannot be represented adequately by a single metric, even abstracting from often severe data limitations. The industry is very diverse. Beyond the basic delineation between financial intermediation and insurance and pension services and other investment services, there are sharply distinct lines of specialization within these different components of financial services, and even among the types of organizations that offer these different product lines. For example, property and casualty insurance is distinct from health or life insurance, and Canada has a significant cooperative sector that offers a wide array of banking and insurance services. A single metric of competitiveness in a given market might be relevant for some firms, given their unique strengths and strategic direction, but might not be as useful to gauge others' situations.

In addition, the competitiveness of a financial services firm in a given market often depends on access to complementary services, such as information, communications, legal or accounting services, as well as the ability to move managers and other skilled employees, data or funds across borders to exploit business opportunities and to

avoid double taxation. Access to such services and mechanisms by Canadian financial services firms in a given market supports their competitive position in that market, all else being equal.

The environment for complementary services and agreements is therefore important in evaluating the competitiveness of the industry proper, and for how Canada's trade and economic diplomacy writ large could facilitate the international growth of sectors in which Canada has an advantage, but in which its firms face policy-induced barriers. All told, this argues for a trade strategy that prioritizes target markets based on available indicators of overall competitiveness in financial services, but also on the availability or ability to open complementary services to trade, as well as mechanisms that enable efficient international exchanges, such as tax agreements or air travel agreements that facilitate exchanges within companies and between a company and its clients. This broad approach will inform our priority market rankings below. For now, we return to considerations of financial services specifically.

Global Reach

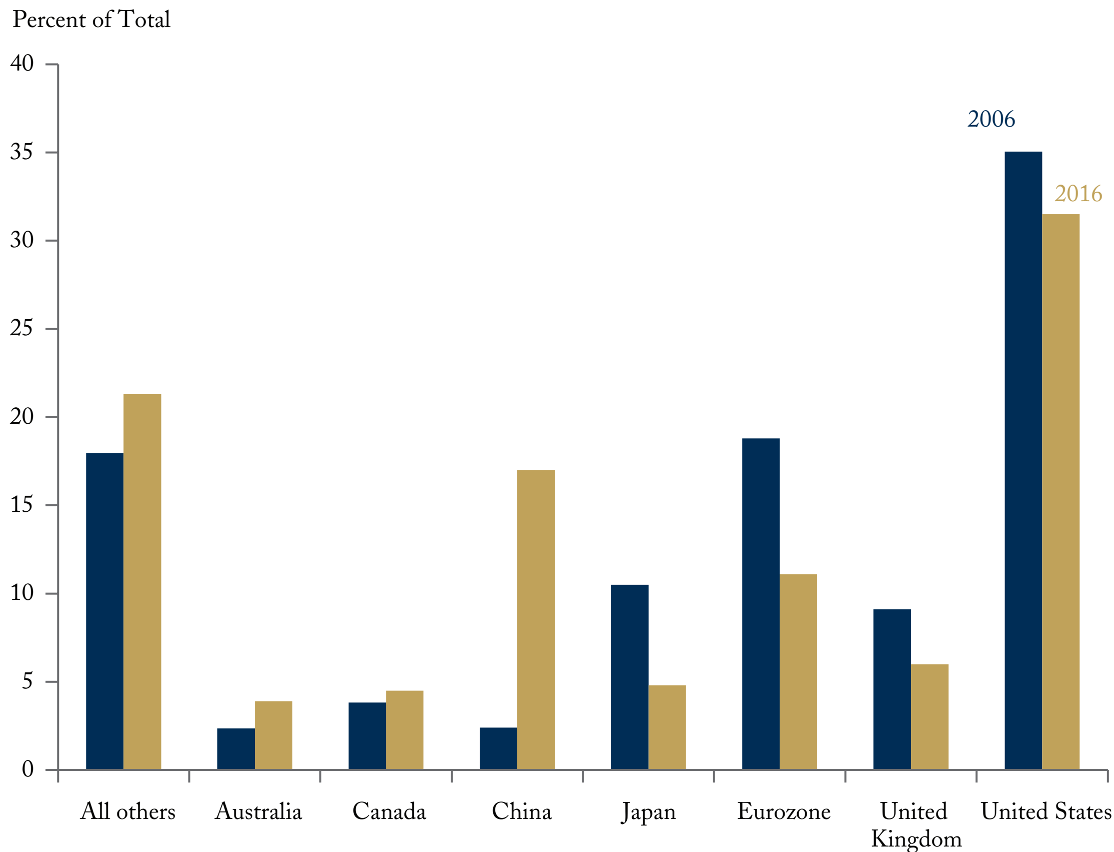
Size matters for firms' ability to take advantage of cross-border opportunities. On that score, the global footprint of Canadian financial institutions has expanded since the global financial crisis. This is strikingly illustrated by the evolution of the share of the market value of all financial firms listed in the Forbes 2016 "Global 2000" rankings, represented by Canadian-headquartered firms (Figure 2). That Canada's share has risen slightly over the past decade is all the more remarkable given the substantial drop in the share of the value of financial services firms headquartered in other G7 economies, while that of Chinese-domiciled institutions and those from other emerging markets has risen sharply. Indeed, Canadian firms' share of the global financial services landscape, at 4.5 percent, is now almost twice the share of Canada's GDP in the global economy, which sits at 2.5 percent. Also of note is the faster rise in the share of Australian institutions. From a foreign trade and investment policy standpoint, it is hard not to relate Australia's faster rise to its relative proximity to, and greater eagerness to deepen its trade engagements with, fast-growing Asian markets, including China.

Trade Data

Since the 2008-09 global financial crisis, Canada has registered a large increase in its surplus on financial intermediation services, a small deterioration in the balance on insurance products, a swing to a brief surplus in 2011–12, then back to deficit for other financial services, which include securities issuance and trading as well as asset management services (Figure 3). The aggregate trade deficit (the grey bars in Figure 3), combining both financial and insurance services, is markedly lower in absolute terms than it was at the beginning of the financial crisis, and even lower as a share of GDP than it was then. This improvement in Canada's balance likely reflects the stronger competitive position of Canadian financial and related services firms, since it has taken place in the context of a rapid increase in two-way trade in these categories. Over the past 10 years, the value of Canadian financial services exports has tripled, that of insurance exports has more than doubled and that of related services exports has increased by 45 percent. Financial services imports have grown by 118 percent, insurance imports by 68 percent and related service imports by 53 percent. These growth rates compare to mere 20 percent and 44 percent increases in the value of all Canadian exports and imports, respectively, over the period.[5]

5 In the case of insurance, the deficit still widened in absolute terms as exports started from a much lower base than imports.

Figure 2: Forbes Global 2000 Market Value of Financial Services Firms, by Country of Headquarters



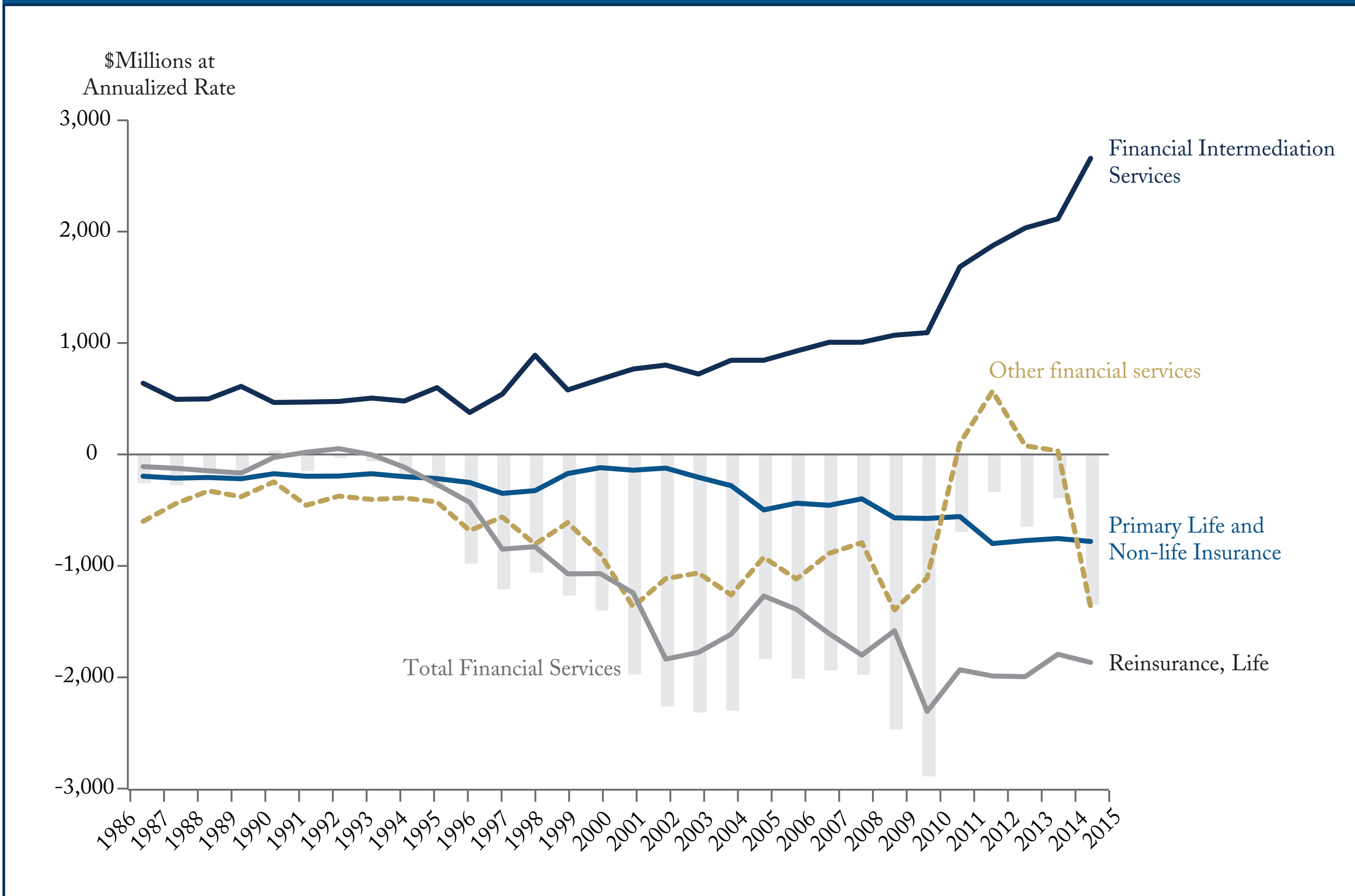
Source: Forbes, "The World's Biggest Public Companies" accessed at www.forbes.com/global2000/list/#tab:overall, and authors' calculations.

Canadian direct cross-border exports of all financial services combined stood at $12 billion in 2015, about double their pre-financial crisis total. This is equivalent to only about 12 percent of the sales of majority-owned subsidiaries or branches of Canadian financial services outside of Canada. In other words, most Canadian financial services firms export services through their affiliates (from which they earn income), rather than directly from Canada.

Comparative Advantage

Another way of assessing the structural importance of this rise in financial services for Canada's economy is to look at measures of Canada's "revealed" comparative advantage (RCA) in that

Figure 3: Financial Services Trade Balances, Canada, Quarterly



Source: Statistics Canada, CANSIM Table 376-0033, accessed October 18, 2016.

sector. A country's RCA in a given type of product is measured as the ratio of the country's exports of that product to its total exports, divided by the same ratio for all other countries.[6] It is a measure of relative strength: a reading above 1 indicates the country is more successful against competitors in the international marketplace in that sector than in other goods and services it exports. Comparative advantage is "revealed" in that the underlying advantages of the economy (skills, knowledge, capital stock, institutions and so on) are said to be revealed by the country's actual trade flows.

6 The denominator we use here is the average of each country's share of a given services export in its total exports, rather than the total share of the given service in world exports, as would be done in a simple Balassa index calculation. This allows the derivation of a RCA index that has the same key attributes as the basic Balassa index in terms of country rankings, but unlike that index it is comparable across time, because its upper bound (the number of countries) is constant. In both cases, the lower bound of the index is zero, and a reading above 1 indicates a comparative advantage, while a reading below 1 indicates a comparative disadvantage. See Amador, Cabral, and Maria (2007).

To the extent the flows are distorted by trade barriers, however, and these barriers affect certain sectors or certain countries more than others, the links between the comparative advantage revealed by trade flows and the actual underlying trade potential for the sector can be "noisy." This means that a reading slightly above or below 1 need not be taken too literally, especially as the RCA data can also be quite volatile from year to year for any given product, depending as it does on changes in trade in all other products.

Nevertheless, trends in RCA can underscore important structural developments. Based on gross exports, financial services occupy a more important place in the structure of Canada's trade, relative to the rest of the world, than they did before the financial crisis (Table 2). The same is true of insurance and pensions services overall, although here Canada remains at a relative disadvantage compared to other exporters that are relatively more concentrated in that industry; this overall number, of course, might mask an advantage in specific product lines. We also include the comparable number for telecom, computer and information services, which have declined since the collapse of much of Research in Motion's old business, contributing to a decline in Canada's measured comparative advantage in this overall sector. Such a decline also has taken place for a composite of business and professional services, for which Canada still exhibits a comparative advantage. This decline is due to the travails of the sizable oil and gas services sector, which is included in the composite "other business services" category.

Table 2 also shows Canada's RCA in all banking, insurance and other financial services combined, based on the Trade in Value Added database compiled by the Organisation for Economic Co-operation and Development (OECD) and the World Trade Organization (WTO). Trade in value added counts domestically produced goods and services, including financial services used in total exports, while abstracting from imported inputs embedded in those exports. This measure shows that Canada has a revealed advantage in the financial services industry overall. Indeed, Canada is the only country of noteworthy size that registers both a significant advantage in natural resources exports and comparative advantage numbers in financial and related services that approach or exceed the threshold of 1. This illustrates why Canada's trade policy should aim at exploiting both its traditional and emerging sources of strength, notably in services.

Table 2: Changes in Revealed Comparative Advantage, Canada, Gross Exports

Type of Export and Year	2005-2008	2009-2012	2013-2015
Based on Gross Exports			
Financial Intermediation Services	0.68	0.92	1.00
Insurance and Pensions Services	0.43	0.86	0.63
Telecom, Computer & Information Services	0.67	0.84	0.61
Other Business Services	1.25	1.40	1.24
Based on Value-Added Trade	2005	2009	2011
All Financial Services	1.18	1.11	1.17

Note: Data are from modified Balassa Index as explained in footnote 6. "Various Business Services" include all business services except Financial Services, Insurance and Pensions, Telecommunications, Computer & Information Services, Goods-Related Services, Intellectual Property, and Travel and Transportation.

Regulation as Competitive Strength

Canada's regulation of its financial system is perceived as a competitive strength, particularly

with respect to its fostering the robustness of Canadian banks and monitoring the stability of the financial system. Prior to the global financial crisis, this feature might have been perceived as limiting the financial system's expansion relative to other jurisdictions. But Canada's ability to withstand the crisis better than competitors in most advanced economies points to the virtuous features of Canada's financial system and institutions.

According to some observers, the new international and national regulatory requirements put in place after the financial crisis may have created unnecessary barriers to efficient expansion of financial services (see, for example, Dodge 2015). Yet, in some respects, prudential Canadian regulation and prudent risk management at the level of individual institutions can be an advantage. For example, the strength of Canadian banks allows them to expand in foreign markets – particularly if their business model supports cross-border lending – while competitors must limit their own expansion due to tighter domestic regulatory requirements (Damar and Mordel 2016).

Recent International Developments

Canada's competitive position in any sector naturally depends on developments abroad. The global financial landscape has undergone a variety of economic shocks since we released our previous *Commentary* on Canadian priority trade markets (Schwanen, Ciuriak, and Kronick 2015), with some of the world's most important financial centres not immune to their negative consequences. On balance, we see some global and specialized centres experiencing adverse impacts from the shocks, while some of the more regional full-service centres are potentially gaining.

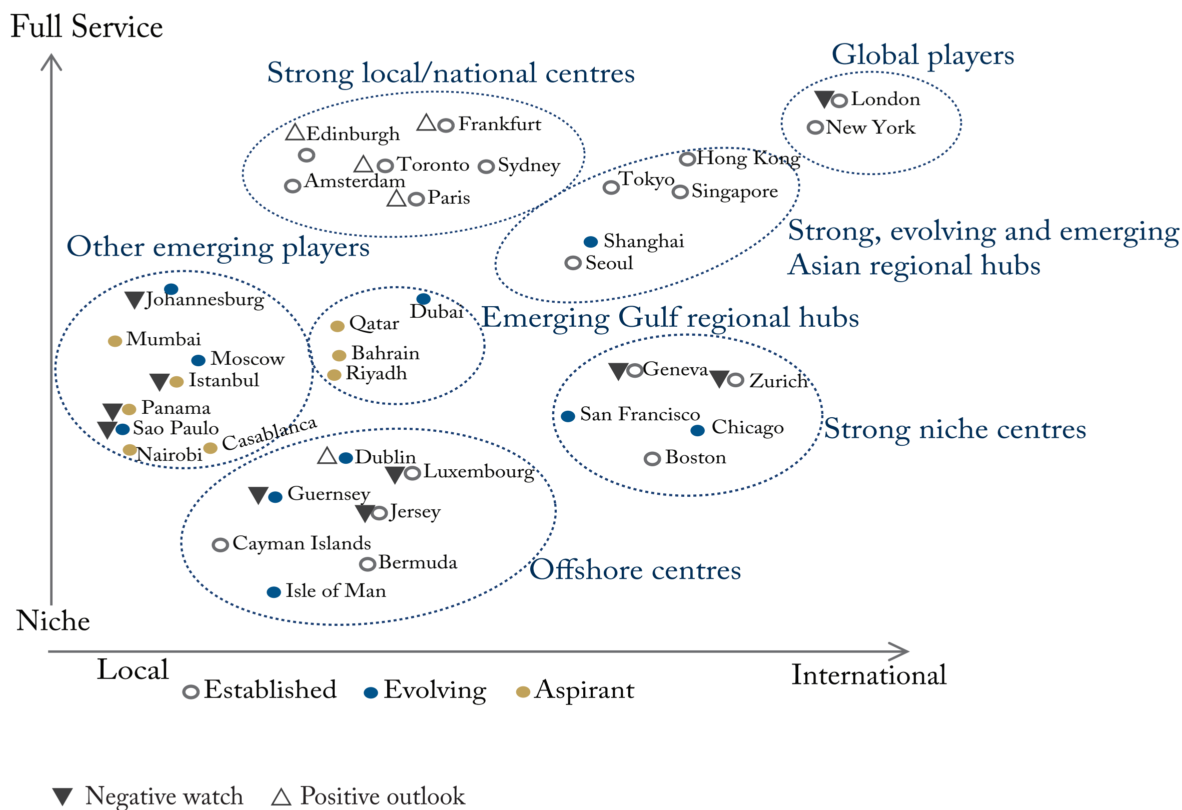
In turn, we can visualize these trends in a modified version of the bubble chart we used in our previous paper to illustrate the relative position of various globally significant financial centres, including Toronto (Figure 4).[7] This version indicates the direction we think some centres might be headed toward as a result of these shocks, thereby representing risks or opportunities for Canadian-based financial institutions.

In Figure 4 we focus on three types of shocks: the vote in the United Kingdom to leave the European Union (the so-called Brexit), the controversy over offshore accounts and the lack of government legitimacy in emerging markets – all of which, we expect, will negatively impact other global financial centres, creating opportunities for Toronto specifically, and Canada more generally.

Brexit: Although Brexit will have global consequences, it likely will reduce London's desirability as a financial centre. Notably, it is likely to lose its privileged position as the world's principal location for euro trading – certainly for euro clearing. As uncertainty embroils Britain's access to the EU market, including the movement of skilled personnel, firms that had considered London as a hub for their European operations likely will be forced to reconsider, notwithstanding London's significant remaining advantages, including connectivity and the use of the English language.

7 In Figure 4, the x and y axes are labelled as "local to international" and "niche to full service," respectively. Using London as an example shows the type of data that go into the location determination. The City of London seeks out international business on a regular basis. It therefore is placed at the far right on the x axis, identifying it as an international financial centre. Furthermore, in London we see a strong co-location of a variety of financial services expertise, including in banking, insurance, derivatives and foreign exchange, which ranks the city high on the y axis as a full-service centre. Note: Montreal and Vancouver, which by some key rankings rate among the top 20 global financial centres, were not included in the source chart.

Figure 4: Canada's Financial Centre, Comparison with the Rest of the World



Source for original country placements: The CityUK based on Citi, Oliver Wyman, and Z-Yen. Negative watch and positive outlook are authors' determination.

The offshore accounts controversy: The leak of the now-famous Panama papers revealed money laundering and illegal offshore accounts of public officials and other prominent figures, amid mostly legal offshore activities. The release of these documents has created significant political risks even for these legal activities. The repercussions have been felt in offshore centres implicated in the revelation, such as Panama, Zurich, and Geneva, which are likely to face increased global scrutiny. The inclusion of Swiss banks in the leaks could make Swiss financial centres less attractive as global players, while also adversely affecting their status as tax havens.

Government legitimacy in emerging markets: Domestic turmoil has been rife in several emerging countries recently, including Brazil, with the impeachment of President Dilma Rousseff; South Africa, with corruption charges brought against President Jacob Zuma; and Turkey, with an attempted military coup. The events in Turkey might attract additional scrutiny regarding that country's entry into the EU, which could affect Istanbul's logical next move toward becoming a more global, fuller-service centre.

Overall, we see Toronto's position as benefiting, at least marginally, from the turmoil in these other markets. At the same time, Canadian financial

services firms operating abroad will have to be mindful of threats, or even opportunities, to their operations in affected countries.

Financial and Related Services and Canada's Trade Negotiation Agenda

We start this section with a short review of provisions of trade and related agreements that most directly concern the financial services sector, and then turn to some basic elements of the implications of financial services openness that should inform Canada's trade negotiating agenda.

Trade and Related Agreements and Financial Services

Financial services tend to occupy a special position in trade and investment agreements. This is because governments rightly wish to retain control over the tools they need to maintain financial stability. This yields the so-called prudential carveout which is standard in trade agreements such as the North American Free Trade Agreement, the General Agreement on Trade in Services, the Comprehensive Economic and Trade Agreement (CETA) between Canada and the EU, the TPP and in Canada's model investment treaty (the country's negotiating text template). This financial services carveout is also included in the negotiations for the Trade in Services Agreement (TiSA).[8] These "carveouts" essentially recognize that trade and investment agreements should not prevent governments from being able to adopt or maintain measures for prudential reasons. These reasons include the protection of depositors, of financial market participants or of "persons to whom a fiduciary duty is owed by a financial institution," the safety and integrity of financial institutions and the stability of the financial system (as spelled out in, for example, NAFTA Article 1410).

Governments also retain the right to distinguish, for prudential reasons, between providers of financial services originating in different jurisdictions when this means they are governed by a different set of rules. Governments are therefore not obligated automatically to grant most-favoured nation (MFN) treatment to institutions domiciled in jurisdictions governed by different rules – indeed, a WTO dispute settlement panel has deemed such distinctions acceptable (see Schwanen, Ciuriak, and Kronick 2015, online appendix). In the case of CETA, however, the parties must allow each other the opportunity to extend recognition to a third party (see Leblond 2016, 3).

At the same time, parties to these agreements also recognize the potential for governments to use the cover of prudential provisions to protect domestic players from foreign competition. This is why disputes concerning financial services matter under trade or investment agreements and are sent to a specialized panel that can determine authoritatively the difference between a legitimate prudential measure and a protectionist one. This takes into account the unique nature of financial services disputes, and fully protects governments' right to preserve the stability and integrity of their respective countries' financial system.

Under trade and investment agreements, regulators – including, in Canada, at the provincial

8 TiSA is currently being negotiated by some 50 countries, including the members of the EU and US. According to Global Affairs Canada (2016), "Canada is participating in negotiations towards a…TiSA. The objective of the Agreement will be to enhance trade in services and improve market access. TiSA Parties represent an enormous services market with nearly 1.6 billion people and a combined GDP of more than $50 trillion in 2015 – nearly two-thirds of the world's economy.… Parties will also be working towards a deadline of late October for the tabling of final market access offers."

level – retain their full ability to license firms and professionals offering financial services to the public, to verify the character of investors and in general to make sure that those offering services deserve the public's trust. In other respects, trade agreements allow for the opening of financial services along lines applicable to liberalized services more generally. In financial and many other services industries, cross-border provision of services needs to be complemented by operations abroad through foreign investment in order to reach customers. Thus, provisions allowing the establishment of Canadian financial institutions ensure that foreign financial institutions can operate on a level playing field with domestic institutions ("national treatment") and permit the movement of skilled personnel and executives. These provisions are essential to the effective promotion of trade in financial services.

As well, complementary treaties that help avoid double taxation of investors in both the home and host countries are typically an important key to providing the degree of comfort that investors need to provide services in a foreign market. Air transportation agreements are also vital to strengthen the ability to offer services across borders, thus facilitating face-to-face interaction between the head office and foreign operations or with customers. In our rankings on the *feasibility* of negotiating financial services opening with different markets, we now take these factors into account.

Implications of Openness to Financial Services

Here we focus first on openness between higher-income countries with a strong financial services sector, such as Canada, and lower-income economies. Subsequently, we discuss openness between high-income economies.

The availability of competitive financial services and the ability of a country's residents to access these services for business or household needs are generally recognized as vital for economic growth. For these reasons, case studies of emerging markets that become more open to foreign competition suggest a generally positive impact, facilitating the deepening of local financial markets and access to finance for residents, inducing local firms to improve their services and efficiency through greater competition and in general having a stabilizing macro-economic influence (BIS 2005).

At the same time, the effects are not universally or automatically benign. They clearly depend on the regulatory and macroprudential frameworks in place – for example, the ability to prevent the too rapid growth of credit, supported by increases in property or other asset values, followed by a crash and withdrawal of foreign capital, as in the case of the 1997 Asian financial crisis. The effects depend as well on rules governing foreign participation and joint ventures, as well as on the existence of a legal and accounting framework that enables lending to, for example, local small and medium-sized enterprises (BIS 2005).

We therefore consider middle- and lower-income economies with high-income growth potential but low RCA in financial services as markets in which both the Canadian industry and the recipient country would benefit from more open trade and investment.[9] Countries ranging from China to Turkey to a number of Southeast Asian and Latin American economies fall in that category. Although these cases are relatively straightforward to contemplate, more complex cases involve a few low-income countries, such as India, whose trade patterns also indicate a comparative advantage in financial services. This is a clear marker that

9 As in Schwanen, Ciuriak, and Kronick (2015), we consider indicators of relative strength in financial services trade also to indicate strength in operating as an investor in a target market through, for example, affiliates or joint ventures.

Canada could explore a more significant two-way relationship in financial and related services with India by, for example, looking to see which complementary services could be performed there, since that country is home to skilled workers and other advantages related to financial services. This is obviously why the question of Indian providers of services is on the table in Canada-India negotiations, at the same time as Canada seeks more access to that market.

Regarding financial services trade with higher-income economies, Canada needs to be mindful of a number of potential markets – and competitors. First of all, it should not neglect high-income countries whose RCA in financial services is considerably below Canada's as potential targets for more vigorous market opening. These include Japan, with which Canada is still formally in bilateral trade negotiations that might resume if the TPP, to which they are both parties, collapses, as well as Australia, Chinese Taipei (Taiwan) and a number of European economies.

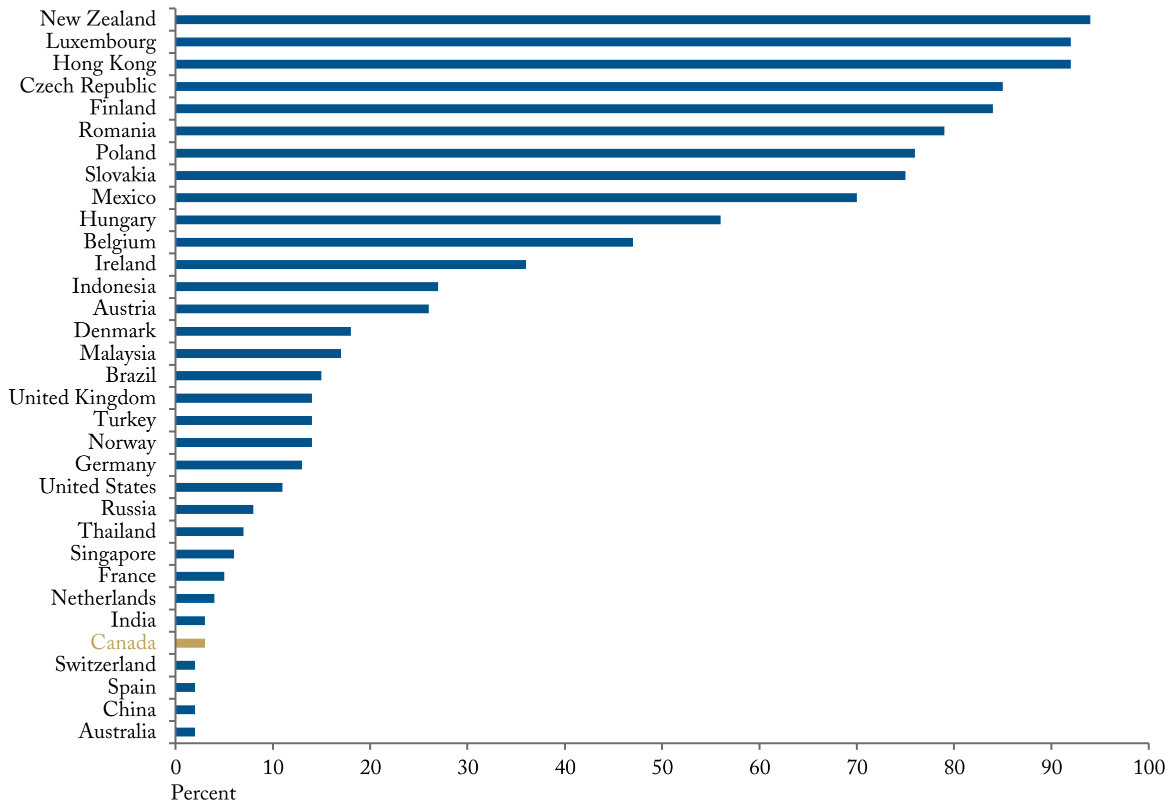
More intriguing is Canada's situation vis-à-vis other large, high-income economies, such as the United States, the United Kingdom and Switzerland (or economies that are key hubs within much larger markets, as in the case of Luxembourg or Hong Kong) that have a much higher RCA in financial services than does Canada. The question vis-à-vis these centres is whether Toronto, as Canada's pre-eminent financial city, will remain a top national full-service financial centre or evolve more toward becoming a global one. Toronto took a major step in the latter direction when it became the first renminbi "hub" in the Americas, which, through the location of a renminbi clearing bank and other facilities, permits easier and less risky trade and investment in that increasingly important currency.

What might be useful next steps? Unlike in many of these other centres, foreign players do not occupy a significant part of the banking landscape in Canada (Figure 5). However, this less visible presence of foreign institutions in Canada does not necessarily equate to a lack of competition. Canada is relatively open to foreign institutions' operations and activities, which compete in a number of segments such as corporate and debt markets, and investment banking and advisory services, including through cross-border trade. Additionally, the evidence suggests that Canada's financial sector continues to be both efficient and competitive[10] – including as technology companies muscle in on what used to be traditional banking markets.

By and large, global and other competitive financial centres also benefit from access to competitive inputs. Compared to countries that outrank Canada for financial sector competitiveness in the World Economic Forum rankings, plus the two other most international players, the United Kingdom and Switzerland, Canada ranked seventh (out of nine) on labour market efficiency (which includes the ability to attract and retain talent) and eighth in terms of technological readiness (which includes connectivity) and higher education (World Economic Forum 2016). To the extent that the inputs, such as specialized skills knowledge and communications and technology services, are not sufficiently available in Canada, the industry would benefit from a specific strategy to encourage their supply. This would include international agreements to open flows of these inputs between Canada and other countries as a way to maintain Canada's global competitive position and, hence, domestic

10 Allen and Engert (2007). These authors show that it is both the domestic and foreign banks that contribute to this efficiency and competitiveness.

Figure 5: Percentage of Foreign Bank Assets among Total Bank Assets – Selected Countries, 2013



Source: Claessens and van Horen (2014).

jobs. For example, Canada needs to debate new approaches that would allow it greater access to skilled personnel and improve the openness of the telecommunications industry, since the OECD has dubbed financial services an "intense user of [information and communications technology] infrastructure" (OECD 2014).

Ranking Priorities Markets for Trade Negotiations

To this point we have shown the growing importance and increasingly robust global position of the financial services sector to the Canadian economy, and touched on the role complementary services and skills play in supporting the sector's competitiveness. We have also outlined how key measures in trade and related agreements and the expected outcome of trade liberalization in financial services, depending on the characteristics of the trading partner, could shape Canada's trade negotiation agenda. It is with this future agenda in mind that we set about to update our methodology and overall rankings of top Canadian trade targets, which we first unveiled in 2015 (Schwanen, Ciuriak, and Kronick 2015).

To better understand the methodological changes, it helps to review the steps we took to arrive at our previous results. Our rankings were based on the simultaneous answers to two questions:

- Where would opening up trade in services provide the greatest benefit to the Canadian economy?
- Where is it most realistic given what we already know about these particular countries?

From here on, we refer to these two questions as ones of *attractiveness* and *feasibility*, respectively.

Generating the Rankings

To get a numerical ranking for *attractiveness*, we used five criteria in our previous study. The first three criteria essentially represented foreign barriers to entry. Specifically, we averaged each country's ranking according to the World Bank's Services Trade Restrictiveness Index (STRI), the OECD's STRI and the state ownership of financial institutions.[11] We then ranked countries by this average, and averaged the results of that ranking with those of a ranking of countries ordered by banking intensity (using bank deposits to GDP as a metric) and another ranking of countries ordered by the average of life and non-life insurance premiums. The combined ranking represents how closed and underserviced are particular countries, with higher-ranked countries being those with more room to open and grow.[12]

We then normalized the results by a country's RCA in financial services. This step boosted the rankings of countries that are at a comparative disadvantage and thus would benefit from open trade with a country such as Canada, with a higher comparative advantage in financial services. We replicate these initial steps in this study. New in this study, however, is the additional use of an RCA for complementary postal, telecommunications and business services. Countries with higher RCAs for these complementary services rank higher, since it implies the existence of a strong infrastructure that Canadian and other firms can take advantage of in offering financial services. We multiply this measure by the results from the steps described above.

With this partial *attractiveness* result in hand, we then looked at future economic growth forecasts for our countries of interest. In particular, we looked at GDP growth in absolute US dollars, forecast over an eight-year period in order to capture long-run, steady-state growth devoid of large business cycle fluctuations. The idea here is that, all else being equal, liberalizing with higher-growth countries will generate greater benefits.

Although this methodology produces country rankings of attractive potential markets, it tells us nothing about the *feasibility* of liberalizing trade with these countries. We do not want Canadian trade negotiators spending significant amounts of time and energy on deals unlikely to be fruitful, hence our introduction of the *feasibility* ranking.

11 For state ownership of financial institutions, we used the World Bank database on Bank Regulation and Supervision: http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTGLOBALFINREPORT/0,,contentMDK:23267421~pagePK:64168182~piPK:64168060~theSitePK:8816097,00.html. Specifically, data exist to answer the following question: "[w]hat percent of the banking system's assets was in banks that were government-controlled (e.g., where government owned 50% or more equity)?" As we noted in our earlier study, the literature shows that banking systems with significant state ownership tend to operate less efficiently than others.

12 We note that, for each indicator of interest, we rank all the countries in our sample. Our decision then to average rankings for each indicator, rather than create an index that is comparable across indicators, is based on differences in the underlying units of measurement. What does it mean to compare restrictiveness index scores to real GDP growth? This type of question makes indexing an unappealing approach. We do have data on where our top-priority countries rank in each category, to give readers an appreciation for the implied weighting that each indicator received.

The first step in calculating this ranking is to determine for each country which other countries it has trade in services agreements with and what is the total GDP of these trade partners. This measurement provides an understanding of the degree to which countries are willing to participate in advanced trade deals. Second, we looked at the percentage of that country's merchandise trade with Canada as a percentage of its GDP. In this case, we are identifying countries that already likely see Canada as an important trade partner for goods, with services being a natural next step. Third, we looked at data on foreign workers in Canada – specifically, temporary foreign workers by country of origin, and that country's participation in the international mobility program. We then averaged these two rankings to provide one measure that represents the degree of complementary skills with that particular country. In our previous study, this was the final step prior to averaging the rankings for these three components.

In this study, however, we have added an additional step. Air transportation and tax treaties are both strong indicators of a country's willingness to participate in the global economy. As such, we have endeavoured to add information on these agreements to our *feasibility* rankings. Our approach was to determine how many air and tax treaties each country has with OECD countries. So, for example, a country that has air treaties with 20 out of 34 OECD countries is accorded 59 percent.[13] We then ranked countries from high to low in terms of percentages, and averaged a country's rankings in air and tax treaties to come up with a final "treaties" ranking to add to our three previous measures. At this point, we took the average rankings of the four measures to get the final *feasibility* results.

With both the *attractiveness* and *feasibility* rankings in hand, we then generated the final overall rankings. For our primary set of results, we evenly weighted *attractiveness* and *feasibility*, as there appeared to be no clear reason to deviate from that formula.[14]

Rankings and Resulting Canadian Priority Markets

Table 3 presents the country-by-country rankings. The rankings should not, however, be followed by rote. The rankings can help inform us, but we also need to interpret them to understand the realities on the ground. For example, Australia is high on our list, but the best bet for getting freer access to the Australian market right now is for the TPP to be ratified by participating countries, including Australia, rather than for Canada to negotiate a new bilateral deal with Australia. In general, if a number of countries are looking for a multilateral trade deal, this would be a better outcome than a bilateral deal, even if the country that is the other half of a bilateral deal ranks above each of the countries involved in a multilateral trade deal.

There are other issues to consider as well as we rank our priority markets. What to do with countries with which Canada already has deals that liberalize trade in services? It is important for Canada to continue to analyze deals those countries are making, as there might be negotiations on issues not covered by Canada's MFN status with that country. This is true whether that country is negotiating on its own or in a group with other countries with which Canada does or does not have a trade in services agreement. Additionally, if direct competitors – that is, countries of a similar size and with a financial services sector similar to Canada's

13 There are 35 OECD countries in total, but we removed from the total the country whose percentage we were calculating.

14 We looked at a 75-25 split in both directions; although there were minor individual country changes, nothing substantive was altered. Results are available upon request.

Table 3: Canada's Trade Agreement Priority Countries

	Rank – Feasibility	Rank – Attractiveness	Overall Priority Rank
Mexico	1	4	1
United States	3	3	2
China	11	1	3
Philippines	7	7	4
Korea, Rep.	2	16	5
India	22	2	6
Germany	20	5	7
Vietnam	16	12	8
Australia	13	15	8
France	20	9	10
Chile	5	26	11
United Kingdom	8	23	11
Indonesia	41	6	13
Malaysia	18	31	14
Thailand	9	41	15
Norway	10	42	16
Japan	26	27	17
Italy	25	28	17
Switzerland	15	43	19
Ireland	4	55	20
Netherlands	11	50	21
Colombia	36	25	21
Dominican Republic	31	33	23
Poland	47	17	23
Brazil	57	8	25
Costa Rica	30	39	26
Romania	51	19	27
Belgium	14	57	28
Spain	38	34	29
Guatemala	24	49	30
Singapore	6	69	31
Sweden	40	35	31
Bangladesh	64	13	33
Saudi Arabia	60	18	34
Morocco	42	38	35
Denmark	36	44	35
Turkey	59	21	35
Peru	17	64	38
Chinese Taipei	61	20	38
Egypt, Arab Rep.	70	11	38
Finland	29	53	41
Argentina	68	14	41
New Zealand	27	56	43
Slovak Republic	53	30	43
Kazakhstan	74	10	45
Israel	32	59	46
Algeria	67	24	46
Czech Republic	46	47	48
Russian Federation	58	36	49
Hong Kong SAR, China	35	60	50
Luxembourg	19	77	51
Sri Lanka	65	32	52
Kenya	76	22	53
Iceland	23	76	54
South Africa	53	46	54
Cambodia	53	48	56
Portugal	34	68	57

Note: Italics represents countries Canada already has a trade agreement in services with.

Table3: Continued

	Rank – Feasibility	Rank – Attractiveness	Overall Priority Rank
Ethiopia	73	29	57
Greece	28	75	59
Austria	45	58	59
Honduras	32	72	61
Hungary	43	61	61
Pakistan	56	51	63
Nigeria	72	40	64
Nicaragua	39	74	65
Senegal	62	52	66
Tanzania	77	37	66
Lithuania	49	66	68
Panama	63	54	69
Estonia	48	70	70
Mozambique	74	45	71
Slovenia	51	71	72
Trinidad and Tobago	44	79	73
Bulgaria	50	73	73
Latvia	66	63	75
Uruguay	71	62	76
Tunisia	69	65	77
Paraguay	78	67	78
Mauritius	79	78	79

Note: Italics represents countries Canada already has a trade agreement in services with.

– are negotiating bilateral or multilateral deals with other countries and Canada is not, Canada is losing out on a potentially significant market.

With that in mind, our results are similar to, but not exactly the same as, the priority markets we identified in Schwanen, Ciuriak, and Kronick (2015).[15]

1. At the top of the list are Mexico and the United States. These rankings suggest the continuing importance of at least maintaining very close tabs on these countries even though Canada currently has a trade agreement with them that includes an MFN clause. Furthermore, many of the signatories to the TPP rank highly on our list, including, of course, the United States and Mexico. These signatories include both other countries with which Canada has an agreement, such as Chile, and ones with which it does not, such as Australia, Japan, Malaysia and Vietnam. Both the Philippines and South Korea, countries that could join the TPP should it or a similar trans-pacific agreement come into effect, continue to rank highly as well. Therefore, it is clear from this list that the Canadian government should support ratification of the TPP unless there is really no pathway for the agreement to be approved in the US Congress, in which case Canada should consider a "plan B" involving the countries on that list. Plan "B" could involve turning TPP signatories' energies to the TiSA currently being negotiated among some 50 countries, including EU members, or, perhaps more realistically, working through the Asia Pacific Economic Cooperation (APEC) forum to advance services openness across the entire Pacific, including in China.

2. China remains a highly valued trade target, due in large part to its *attractiveness*, highlighted by its market size and the room for further

15 As in Schwanen, Ciuriak, and Kronick (2015), these priorities are in addition to CETA and its corresponding EU countries. Despite difficulties surrounding ratification, this trade deal has already been negotiated.

opening through the privatization of state-owned enterprises and the easing of restrictive capital flow policies.[16] The latter issues will make negotiating difficult, even abstracting from the political and security questions that inevitably arise when dealing with this still-emerging giant. As China continues to grow and open up to the world, Canada will not want to be left behind. China's desire to open its markets further to foreign firms might become less pressing, however, if the TPP were to fall apart, as China might see the agreement's demise as an invitation to assert its own economic model in the region. This would make it more difficult for Canada to obtain gains in a bilateral setting.

3. Also high on the list is India. Similar to China's, its *attractiveness* should draw the attention of Canadians. India is a high-growth emerging market that remains relatively restricted, and as such represents an opportunity for Canada. India ranks in the top 25 in *feasibility* as well, but that comes with a caveat: specifically, its high ranking here has less to do with its trade with Canada or with trade deals in general and more to do with the entry of Indians into Canada as temporary foreign labour. We put countries with elevated levels of temporary foreign workers and international mobility high on our list, but politically this is not always viewed in the same light. This latter issue will have to be addressed, perhaps with quotas on temporary workers, as it is weighed against the benefits that a trade agreement in services with India would generate. Having said this, its new model Bilateral Investment Treaty shows that India is considering further opening up to foreign investment – another reason to see it as a good potential partner.

4. ASEAN countries such as the Philippines, Indonesia and Thailand continue to rank in the top 15. These are countries with which Canada has no bilateral or multilateral trade agreements, and all offer different strengths. The Philippines ranks highly from the standpoint of both *feasibility* and *attractiveness*. Indonesia ranks highly in *attractiveness*, as it has a significant competitive disadvantage in financial services and continues to have significant state ownership of financial institutions, while also having high economic growth potential. Thailand, in contrast, ranks highly in *feasibility*, as it has become much more willing to negotiate trade deals with other countries and it also has a high level of trade with Canada. Canada should consider a trade agreement with ASEAN, such as Australia and New Zealand have already concluded.

5. In this last set of priority markets, we break form, as two disparate countries – the United Kingdom and the Dominican Republic – stand out in the rankings. As we mention in the case study of Brexit (Appendix A), it is interesting to note that, under reasonable assumptions, the United Kingdom remains a top target. Given the size of its market, the importance of labour mobility both ways with Canada and its likely high willingness to trade, Canada should look at the United Kingdom as a priority market. The Dominican Republic is also an interesting emerging market for Canada to consider, as it ranks above average in both *attractiveness* and *feasibility*. Indeed, it might stand as an exemplar for other countries in the Caribbean and Central American region as a whole, which are not themselves powers in financial services but have shown a clear interest in liberalizing trade, including in services, and have good growth prospects in the heart of a fast-evolving

16 Appendix B describes the evolution of the openness of China's financial sector in more detail.

region. Here there seems to be a natural, if underappreciated, fit.

We do not rank the Pacific Alliance – a trade bloc encompassing Mexico, Colombia, Chile and Peru, all countries with which Canada already has trade agreements – as highly as in our previous study. This is because Peru fell significantly from its previous ranking due to our adding the complementary services variable, on which Peru ranks low. However, Mexico, Colombia and Chile continue to rank highly as a group. This result gives an example of where Canada should also focus on opening markets for competitive complementary Canadian services, in addition to financial services.

As with our previous rankings, Africa deserves a closer look, although no African country ranks higher than thirty-fifth. Sub-Saharan Africa's real GDP growth in 2014 was over 5 percent, behind only emerging and developing Asia in the International Monetary Fund's country group breakdown (IMF 2016). Growth in sub-Saharan Africa slowed somewhat in 2015, although these countries still outpaced world economic growth. Indeed, over the 2010–15 period, only developing countries in Asia experienced more growth than those in sub-Saharan Africa. In December 2015, China staked a claim in Africa's continuing development by promising to invest $60 billion over the next three years (McGroarty 2015). Although the top-ranked sub-Saharan African country, Kenya, comes in only fifty-third, that is likely due to its poor ranking in *feasibility*, which might reflect a lack of opportunity, rather than a lack of will, for trade deals. Sub-Saharan African is no doubt risky given concerns about levels of corruption and the ease of doing business.[17] Nonetheless, it is a market Canadian trade negotiators should consider, especially as part of a broader Africa strategy involving other Canadian goods and services.

Conclusion

Canada's financial services sector benefits from a strong and expanding domestic base, but how and where it expands globally is critical to its future growth. Accordingly, services should be front of mind for Canadian trade negotiators. We have prioritized countries of interest for this endeavour, and we have included countries with which Canada already has an agreement, both to check Canada's past negotiating priorities against our rankings and as a reminder that, in many cases, they remain priorities for better access in the future.

We have not put EU countries at the top of the "to do" list for Canadian negotiators, where they would otherwise rank, because, despite the expected travails of the ratification process, Canada has already signed a deal (CETA) with the EU. Post-Brexit, both the EU and the United Kingdom would remain near the top of the list, despite what can only become more limited access to the EU from a British base.

What emerges from our rankings is, first and foremost, the continuing importance of the TPP signatories, given the high rankings of Mexico, the United States and Chile, all of which Canada has agreements with, as well as Australia, Japan, Malaysia and Vietnam, with which Canada does not. Although the TPP agreement itself is in hot water politically, notably in the United States, supporting something like it, or a "plan B" involving the countries on that list, should be on the Canadian government's agenda. Plan "B"

17 The average ranking of sub-Saharan African countries in terms of the ease of doing business there is 143rd, according to the World Bank (2015). Furthermore, many sub-Saharan African countries rank near the bottom of Transparency International's 2015 Corruption Perceptions Index.

could involve turning TPP signatories' energies to the Trade in Services Agreement currently being negotiated among some 50 countries, including EU members, or, perhaps more realistically, working through APEC to advance services openness across the entire Pacific, including in China.

Indeed, China is next on our priority list. From an *attractiveness* standpoint, China ranks at the top, as it is a fast-growing emerging market but remains fairly closed, meaning there is much potential in principle for a trade agreement with that country to have a substantially positive effect on Canada. At a minimum, efforts should continue to set the stage for more open economic relations with China.

India is another high-growth emerging economy that is very attractive, but questions persist on the *feasibility* of Canada's making progress here. Nevertheless, despite labour market concerns that have derailed previous attempts to conclude a trade agreement, India remains a strong candidate.

ASEAN countries such as the Philippines, Indonesia and Thailand continue to be valuable targets for Canadian trade negotiators. All have different strengths and weaknesses, but both individually and, perhaps more important, as a group – since they have collectively signed trade agreements with a number of larger economies and are putting renewed emphasis on services negotiations among themselves – they offer much from a Canadian perspective.

In the Americas, we suggest that the Dominican Republic could be a new and interesting target for Canada, given that it is not itself a power in financial services, but has shown a clear interest in liberalizing trade, including in services, and has good growth prospects in the heart of what is a fast-evolving Caribbean basin. Pacific Alliance countries have actually dropped in our rankings, but this is mostly because of Peru's lower ranking. Since Canada already has agreements with all four countries in the Alliance, it should observe and, as warranted, offer to join efforts to open trade in services among these players, and between the Alliance and Canada.

Overall, our work points to the desirability of openness for Canada's financial and related services sector, given Canada's existing and emerging strengths in that sector and, indeed, the sector's overall catalytic role in the Canadian economy. With a number of forces currently pushing back against more open international trade, Canada has much work to do if it is not to be left out of promising markets that would allow it to grow in products in which it has a comparative advantage, including financial services. The priority negotiating list we offer here is, we hope, a helpful reminder of that challenge. In that light, we will continue to track the progress of any negotiations, and update our rankings based on new trade agreement developments and financial and economic information as they emerge.

Appendix A: United Kingdom Case Study

On June 23, 2016, voters in the United Kingdom chose in a referendum to leave the EU. Although the referendum was advisory, the results have led to a sea change in the UK government, with new prime minister Theresa May publicly committing to give effect to the voters' choice in favour of "Brexit." At the time of writing, it appears that only a general election won by a party committing to remaining in the EU – itself implying a major realignment in British politics – could undo the results of the referendum. So far, no such election is in the cards.

These developments have considerably increased uncertainty around the economic prospects for the United Kingdom, as well as for the EU and the global economy. The United Kingdom is heavily dependent on foreign capital inflows, given its current account deficit of nearly 6 percent of GDP, the worst in the OECD. Although the United Kingdom accounts for 15 percent of the EU's GDP, it is home to almost a third of all foreign direct investment in the EU from non-EU sources.

Many features of the United Kingdom make it intrinsically attractive to investors, ranging from the use of the English language to an efficient communications infrastructure and relatively low business taxes. But its attraction also reflects foreign investors' current unfettered access to the EU market from a UK base, and to many other markets on a preferential basis through EU trade agreements. Indeed, close to half of UK exports are destined for the rest of the EU. This unfettered access is now in doubt, as the United Kingdom's entire trading relationship with the EU will need to be renegotiated.

In addition, the status of hundreds of thousands of UK nationals entering the rest of the EU every year to take up temporary residence for work purposes, and vice-versa, is now in question. This is because the underlying arrangements concerning the temporary movement of labour are intertwined, like the trade arrangements, with membership in the EU – and a major theme of the pro-Brexit campaign was to enable the United Kingdom to institute restrictions on the free movement of labour.

The sharp drop in the pound since the vote represents an immediate loss of confidence in the United Kingdom's economic future outside the EU, but it has also helped allay some fears about the immediate impact of Brexit on the UK economy. It has made spending in the United Kingdom more attractive to foreign investors and travellers and wages paid in pounds more competitive. However, it also heralds a drop in the average standard of living in the United Kingdom; how much of a drop, in the long run, will depend heavily on the conditions under which UK goods, services and individuals will be able to access foreign markets once Brexit comes into effect.

Any such decline could be alleviated if the United Kingdom were to create some new advantages – for example, through trade treaties with partners with whom the EU has not yet been able to negotiate an agreement, applying less onerous regulation than does the EU (for example, as they apply to the digital economy) or even by smartly reinvesting the net £9 billion annually it would no longer, under a complete divorce scenario, have to contribute to the EU budget. It is hard, however, to see these potential gains offsetting the negative effects of leaving the larger market, except over the very long term.

Future Scenarios and Their Implications for Canada

The "hard Brexit" option, defined as the United Kingdom's leaving the EU without some sort of agreement to maintain reasonably barrier-free trade between the two, is in our view mainly a tactical option. As a strategic end point, it is not in anyone's long-term interest except that of parties that would benefit from a weaker UK and EU. The United Kingdom will still be an important market for the rest of the EU; it now absorbs one and a half

times the amount of EU exports as Switzerland and Norway combined, two economies with which the EU has very open trade – less than if they were within the EU, but far more than if they simply had a trade agreement such as CETA with the EU. In the same vein, specific countries such as Ireland or a potentially independent Scotland would suffer severely from the dislocation of EU-UK free trade and movement of people.

Thus, the professed hard stance on the part of many in the EU toward negotiating with the United Kingdom might well turn to openness toward a "soft Brexit" after the French and German elections in 2017. What, then, would a post-Brexit arrangement look like? Whatever the outcome, full freedom of movement is unlikely, and for this reason we believe the "Norwegian" option is not in the cards: Norway contributes to the EU budget, must abide by EU standards and must accept the free movement of people without being represented in EU bodies. In short, it represents the very things that Brexit stood against. What Norway gets in return is the sheltering of its agricultural sector from EU policies.

Excluding "hard Brexit," this leaves three other plausible scenarios that might respect the essence of the pro-Brexit vote:

1. The Swiss-EU scenario or some variant thereof. Switzerland is not part of the EU, but has a series of arrangements that ensure equivalency of standards and cooperation – for example, on transportation – that essentially permit open trade in goods and services and include participation in myriad joint projects, from research to infrastructure. The Swiss contribution to the EU budget is smaller than Norway's. A key aspect of these arrangements – which are becoming increasingly complex as EU legislation and regulations evolve – is that, after recent negotiations, the Swiss might be able to uphold some local preferences in hiring, although not an overall quota for EU workers. This option might well appeal to the United Kingdom, and the EU might not be able to refuse it to London, in the interest of maintaining a relatively cohesive European economy.

2. The Canada-EU-UK scenario. Under this scenario, Canada, the EU and the United Kingdom continue to apply CETA – assuming it is ratified or at least provisionally applied by the EU and Canada – once the United Kingdom has exited the Union. CETA is by far the most advanced trade agreement negotiated by the EU, and it would be much better for both the United Kingdom and the EU to treat the former as a successor state to this agreement than have the relationship revert back to basic WTO rules, notably regarding services. None of this would be automatic, as some of the quotas affecting certain commodities would need to be apportioned among the three parties. But the template and zero tariff lines and rules of origins could be fairly simply adapted, with or without the controversial investor-state dispute settlement mechanism.

3. The EU reform scenario. Here the EU, bowing to internal and external political pressures from the United Kingdom and Switzerland, would allow some control on the free movement of labour – for example, allowing countries to designate limits for occupations that experience a high unemployment rate or declining wages, though no overall quotas. If the pragmatic pro-EU parties survive the expected protectionist onslaught in the coming elections, they might well respond to the reality that some Europeans feel threatened by unfettered free movement of labour by allowing member states some such degree of control.

Although higher barriers between the United Kingdom and the rest of the EU might make some Canadian products more competitive by default in either market, slower UK growth, even if temporary, combined with the loss of a generally pro-trade UK voice in EU institutions, would have serious negative consequences for Canada as a whole. Since any bank based in the United Kingdom would lose its "passport" that allows it to operate across the EU without approval from other EU member states,

under all the above-mentioned scenarios (except for the unrealistic Norwegian option) it is inevitable that Canadian banks established in the UK would face greater barriers operating across the giant EU market.

Where Should the United Kingdom Sit on Canada's Financial Services Trade Priority List?

What would happen to the United Kingdom's ranking based on the various Brexit scenarios? In our *attractiveness* rankings, it is reasonable to assume that Brexit will not make restrictiveness to services trade worse; in fact, it might actually improve, as the United Kingdom will want to loosen any existing barriers to retain its pre-eminence in Europe in financial services. We therefore leave the United Kingdom's rankings in this category alone. Similarly, it is hard to imagine state ownership in the financial services industry or life/non-life insurance premiums per capita changing as a result of Brexit. Where we should see changes are in banking deposits as a percentage of GDP, economic growth over the next eight years and in revealed comparative advantage.

As businesses, including financial services companies, relocate some of their operations out of the United Kingdom, domestic bank deposits should decrease. Given the United Kingdom's RCA in the financial services sector, bank deposits likely would take a significant hit. Now, the variable we analyze is bank deposits relative to GDP, so if the economy shrinks, as many expect, the effect on the overall ratio is unclear. For simplicity, we assume the ratio would remain the same.

Following the IMF, we change the United Kingdom's projected real GDP growth rate for 2016 from 1.9 percent to 1.7 percent and the 2017 estimate from 2.2 percent to 1.3 percent. We assume that, by 2018, the UK economy returns to the trend the IMF previously predicted. Furthermore, we assume the United Kingdom's RCA for both financial and complementary services drops from 2.39 and 1.79, respectively, to levels similar to those for the United States (1.39 and 1.50). Under these changes, the United Kingdom would remain a top global player, but less of a force than before Brexit – attributable not only to higher barriers, but also to the increased difficulty of attracting talent, given the lower pound and the likelihood of new restrictions on labour coming into the United Kingdom from the EU.

With these modifications, the United Kingdom's position in the *attractiveness* rankings would rise. Why? Remember that a lower RCA in financial services represents an opportunity from an *attractiveness* point of view, while a lower RCA in complementary services is a trade detractor. The drop in RCA for financial services would be more severe than the decrease in RCA for complementary services, leading to a higher *attractiveness* result.

Turning to *feasibility*, Brexit's impact on the United Kingdom's ranking would be minimal in some areas, including our proxies for the ease of labour mobility between Canada and the United Kingdom. Similarly, there are unlikely to be any changes in the tax treaty rankings, as these are bilateral, although we need to assume that the United Kingdom will be a successor state to the EU with respect to air agreements.

Furthermore, since we rank countries by how much trade they have with Canada as a percentage of total GDP for that country, we would expect trade levels to go down if the United Kingdom were no longer part of the EU, especially in light of CETA. As mentioned above, however, we would expect the United Kingdom's GDP to decline as well. We therefore assume that the ratio itself would remain the same, and thus there would be no change in the United Kingdom's ranking on that score.

One area, however, would experience significant change. Since we also rank countries based on the total GDP of all countries with which they have trade agreements, as the United Kingdom likely will have to renegotiate all of its trade agreements, it is unclear what its level of GDP will be. Our working

assumption is that the United Kingdom will remain an attractive trade partner for many countries outside the EU, and will be able to renegotiate relatively easily with those countries. As for the UK-EU relationship itself, as indicated above, it is not clear which scenario will play out. As such, if we remove the EU as a trade partner and thus subtract its level of GDP from trade partner GDP for the United Kingdom, the United Kingdom's *feasibility* ranking drops, which in this case does not reflect the difficulty of negotiating a deal with the United Kingdom per se, but the uncertainty around access to the wider EU market from a UK base.

The resulting overall ranking for the United Kingdom actually would go up from eleventh to tenth. This result is perhaps counterintuitive at first glance, but it reflects the fact that, should London lose some of its lustre as a global financial hub, there might be opportunities for Canadian financial firms. As such, Canadian trade negotiators should continue to consider the United Kingdom a trade priority market.

Appendix B: China Case Study

Despite a growth slowdown over the past two years, worries about the misallocation of financial resources and other risks, China has a rising middle class, with all this implies for growing demand for efficient financial services. In particular, a still very high savings rate and a continuing clear, if gradual, trend toward the deregulation of financial services and the greater openness of capital markets continue to make China a top potential market for Canadian firms.

Analysts, such as those at the Bank of Canada, reckon that the potential real growth rate of China's economy over the next 15 years is approximately 6 percent per year. Clearly, deregulation, greater transparency and continued improvements in international openness to financial firms and capital flows are crucial to China's ability to reach this potential.

Interest rate deregulation, set into motion last year, should help reduce distortions that have encouraged players to seek riskier returns in real estate and the stock market and starved institutions of private funds that could flow to the small business sector. At the same time, it has made the competitive environment challenging for banks, both domestic and foreign.

There has been a gradual internationalization of the renminbi through the government encouraging greater use of the currency in foreign trade and opening the door more widely to foreign-owned investments in renminbi-denominated securities (through the Renminbi Qualified Foreign Institutional Investor program, RQFII). This, in turn, implies the reduced ability on the part of the People's Bank of China to keep the currency undervalued for long, which will support the desired rebalancing of the economy away from export-driven growth and specifically toward the expansion of the domestic services sector, which the Chinese government desires.

In the context of more openness and competition, the efficient allocation of capital would also be enhanced by the public campaign to clean up corruption. However, 15 years after China's entry in the WTO with the stated goal of making its financial institutions subject to foreign competition and operate on a more commercial basis, a large chunk of the Chinese financial system remains influenced by the government, and foreign entities remain very constrained in their ability to compete.

The four major state-owned banks naturally serve a policy purpose. The state also retains control of four major "equitized" banks that do, however, allow minority private foreign ownership. The latter, in theory, operate on a commercial basis, but there are claims that they contribute to non-performing loans due to government influence in their day-to-day affairs (Martin 2012).

China also maintains restrictions on the foreign ownership of domestic financial institutions. For example, foreign banks can own only up to 20 percent of, at most, two domestic banks, and foreign mutual funds cannot own Chinese fund management companies. However, there has been a gradual opening for wholly owned banks (through a loosening of requirements to be capitalized by the home country, for example) and investment funds (there is now mutual recognition of publicly offered funds between Hong Kong and mainland China). Although China still relies enormously on Hong Kong as a financial conduit between it and the world – for example, the RQFII quotas are still allocated mostly to investors based in Hong Kong – there is an explicit push to make Shanghai an international financial centre, gradually strengthening in parallel with deregulation and opening to foreign capital.

In the medium term, there is no question that Chinese consumers will increase their demand for more stable savings products, insurance products and mutual funds and pensions, and that the

Chinese financial system will be characterized by its reliance more on two-way investments, rather than just exporting capital. China will also need to strengthen its regulatory infrastructure and competition regime, needed if a modern financial services sector is to allocate capital efficiently.

Will Canadian financial institutions have equal footing, and sufficient room and flexibility, to compete in these markets, which are expanding quickly but where competition is also intensifying?[18]

China and Canada: Economic Diplomacy Prospects

Given China's enormous weight in the global economy, second only to that of the United States, Canada has a considerable interest in seeing that China continues to grow along a stable path. As the Bank of Canada's senior deputy governor has noted, it is hard to overstate how much economic links between Canada and China have increased over the past 15 years, with two-way trade more than quintupling over the period, supported by some 400 Canadian companies now operating in China (Wilkins 2016).

The key for Canada, given its services strengths, is to engage China in further loosening its remaining restrictions, which will not serve it well in the long run, and to persuade it to collaborate on implementing liberalizing measures. Thus, the presence of foreign institutions from advanced, well-regulated economies such as Canada's could stimulate and stabilize the Chinese domestic market. Canadians could also offer long experience in providing related services, such as trading and advisory services.

With the Canadian government very publicly exploring a further expansion of Canada's trade relationship with China, one of its priorities should be to create more room for Canadian providers of financial and related services to operate in China. In that vein, if Canada does launch fresh trade negotiations with China, it should aim, at a minimum, for results similar to those obtained by Australia in its recently implemented bilateral agreement with China. That agreement was the first bilateral deal in which China committed to the fresh, if modest, liberalization of financial services, including new market access in the banking, insurance, funds management and securities sectors (see Australia 2016). These changes include, for example, removing the two-year profit-making requirement as a precondition of the provision of local currency services, streamlined approval to expand branches, increasing the number of branches conducting renminbi business and allowing Australian bank subsidiaries in China to engage in credit asset securitization business provided for under China's Financial Institution Credit Asset Securitization Pilot Program.

China is also allowing Australian insurance providers access to its lucrative statutory third-party liability motor vehicle insurance market without establishment or equity restrictions, a first in a Chinese trade agreement. The deal will also allow Australian securities brokerage and advisory firms to provide cross-border securities trading accounts, custody, advice and portfolio management services to Chinese Qualified Domestic Institutional Investors – that is, Chinese investors allowed to invest offshore. Similarly, Australian financial service providers will be able to establish joint-venture futures companies with up to 49 percent Australian ownership (foreign participation was not previously permitted). As well, China will expand the ability of Australian firms to participate

18 Including an increasing share of financial transactions conducted over smartphones, which have a very high rate of penetration in China.

in its domestic underwriting business. Australia and China have also "agreed to review bilateral taxation arrangements as part of the forward work program to improve trade and investment conditions following the implementation of the FTA" (Australia 2016).

In its talks with China, Canada should also offer regulatory support and technical infrastructure to help smooth the flow of information and trades. It should seek to minimize red tape, such as regulatory reporting requirements and restrictions on the operations of head offices between different types of financial services, and paperwork required of customers. Canada should continue to seek greater opportunities for investment and partnering with local institutions.

Finally, yet important, is the movement of skilled labour, business people and providers of related services. This should be paired with other initiatives – for example, fewer restrictions on local content requirements – that ease the way for Canadian businesses more generally. Canada should also consider joining, and encouraging China to join, related regional initiatives such APEC's Regional Funds Passport, which is scheduled to come into effect in 2017.

What This Means for Our Rankings

Despite the current lack of engagement and obstacles, China is high in our rankings. Like the rest of China's economy, its financial services sector is being rapidly transformed. The story of the increase in China's *feasibility* ranking from fifteenth to eleventh seems to be driven mainly by its higher ranking in international mobility than in our previous study and by its high rank in both our new variables, air and tax treaties. These increases were enough to offset China's fall in both the total GDP of its trade partners and its trade with Canada as a percentage of its GDP. Notably, China's position in the temporary foreign workers program remained essentially the same.

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